Business Incentives and Taxes

A California Overview

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EDD Employment Development Department
State of California

Business Incentives

California has made a concerted effort to encourage new investment and reduce the cost of starting and operating a business through the creation of various incentives and programs available to businesses operating in the state.

Enterprise Zones *(Targeted Tax Areas, LAMBRA)*

The Enterprise Zone Program spurs business development in designated communities through special zone incentives. Businesses located within the boundaries of an enterprise zone are eligible for tax credits against their California bank and corporation tax liability.

The first major enterprise zone tax credit is equivalent to the sales and use tax paid on the first $20 million of new or used manufacturing equipment purchased each year. Qualified machinery is the machinery or machinery parts used to:

- Manufacture, process, fabricate, or otherwise assemble a product;
- Produce renewable energy resources; or
- Control air or water pollution.

The definition of "qualified property" has been expanded to include data processing and communications equipment including, but not limited to, computers, CAD systems, copy machines, telephones systems, and faxes. Equipment must be purchased in California unless equipment of comparable price and quality cannot be found in California.

Secondly, businesses may claim a percentage of the wages paid to a qualified employee as a tax credit. The credit is based on the lesser of the actually hourly wage or 150 percent of the state established minimum wage. The credit is provided over a five year period with 50 percent of the wages creditable in the first year of employment, 40 percent the second year, 30 percent the third year, 20 percent the fourth year, and 10 percent the fifth year. If the employee were to stay with the company for the entire 5-year period, the company would receive credits totaling nearly $32,000 per qualified employee. If the employee is terminated prior to 270 days of employment, the credit is recaptured.

Other zone incentives that may apply include:

- A 15-year carryover of up to 100 percent of net operating losses (suspended until 2004).
- Expensing of up to $15,000 of certain depreciable property.
- Lender interest income from loan to zone businesses is deductible. *(Not in LAMBRA.)*

Note: LAMBRA (Local Agency Military Base Recovery Area) zones are a companion to Enterprise Zones. The most notable differences in incentives include enhanced equipment purchase eligibility under the sales and use tax credit and redefinition of qualified employees to include displaced military or civilian employees of the former base.

Research and Development Tax Credit

Designed to encourage companies to increase their basic research and development activities in California, the research and development tax credit allows companies to receive an 15 percent credit against their bank and corporation tax liability for qualified in-house research expenses, and a 24 percent credit for basic research payments to an outside organization. This is one of the highest R&D tax credits in the nation. To qualify, research must be conducted within California and must not include research for the purpose of improving a commercial product for style, taste, cosmetic, or seasonal design factors.

Net Operating Loss Carryover

California tax law allows businesses that experience a loss for the year to carry this loss forward to the next year in order to offset income in the following years. New businesses can carryover 100 percent of their losses for eight years if the loss is in their first year of operation, 100 percent over seven years if the loss is in their second year of operation, and 100 percent over six years if the loss is in their third year of operation. Existing California business can carryover 50 percent of their losses for five years.

Note: AB 2065 Oropeza, Chapter 488 suspended the deduction for net operating losses (NOLs) for the 2002 and 2003 taxable years, then makes the NOL deduction 100 percent thereafter.

Child Care Tax Credit

Companies who pay or incur costs for the start up of a child care program or construction of an on-site child care facility are eligible for credits against their bank and corporation tax liability.

Employers may claim a credit, not to exceed $50,000, equal to 30 percent of the costs of establishing a child care program or constructing a child care facility for use primarily by their employees' children.

Also, employers may claim a credit (not to exceed $360 per dependent per year) equal to 30 percent of their contributions to a qualified child care plan made on behalf of any dependents, under age 12, of their California employees.

Excess credits may be carried over to succeeding years.

Redevelopment Area

Various forms of financial assistance are available through local redevelopment agencies in California. Business may benefit through direct financial assistance, land assemblage, and construction of public improvements. Redevelopment is funded through incremental property tax revenue increases that are a direct result of private investment and increased property values.

Assistance may be in the form of fee reductions, infrastructure improvements, land cost reductions, mortgage interest reductions, and utility tax rebates. Recent legislation enables the Redevelopment Agency to provide financing for manufacturing projects under certain conditions. Capital financing or long term operating leases may also be permitted.

Job Referral and Placement

Employment Development Department works with businesses to access the state's entire workforce as well as coordinate recruitment activities with local community based job training and placement organizations called “One-Stop Career Centers”. EDD, in cooperation with the One-Stop network, will help to customize and deliver pre-employment and on-the-job training; recruit, screen, and assess workers for specific skills sets; and assist employers to maximize California Enterprise Zone and federal hiring tax credits.

Also through its CalJOBS^{SM} system, EDD’s Job Service offers a statewide network that provides an instant link between employers and job seekers anywhere in California. This network provides employers with quick access to the largest available pool of job-ready applicants.

<u>Local & Federal Training and Hiring Incentives</u>

- On-the-Job training contracts provide up to 50 percent wage reimbursements during an established training period for employees meeting specific qualification criteria.
- The federal Work Opportunity Credit equals 40 percent of the first $6,000 in qualified wages in the first year, provided the employee works at least 400 hours during the tax year.
- The federal Welfare to Work credit equals 35 percent of the first $10,000 in qualified wages in year one and 50 percent of the first $10,000 of qualified wages in year two, each time a qualified employee is hired.

California Employment Training Panel

The Employment Training Panel (ETP) assists businesses in acquiring and retraining a highly skilled work force with expertise in very specific fields in order to increase competitiveness and productivity. The ETP will enter into a performance-based customized training contract, for new or existing employees, that is performed by either an approved training agency or the company itself. As the training is completed, the costs for developing, implementing, and completing the training are reimbursed. Ranging from about $1,500 to $2,000 per employee, reimbursements are made to the company for each employee that completes training and remains on the job for 90 days. The program is open to all California companies that face out-of-state competition and meet one or more of the following conditions:

- A need to retrain current employees to prevent layoffs.
- A need to upgrade workers in areas where there are skills shortages.
- A desire to hire and train unemployed workers eligible to receive unemployment insurance.
- Special or unique training needs in industries related to defense conversion or emerging technologies.

State Taxes

California ranks about 23rd among the states in total state and local tax collections per $1,000 personal income. As a result of state spending limitations and Proposition 13's limit on property tax, California taxes are competitive with neighboring states.

Corporation Income Tax

The Franchise Tax Board administers an 8.84 percent tax on net corporate income that is known as the bank and corporations franchise tax. S Corporations are subject to a tax rate of 1.5 percent on net income.

California uses the unitary method to determine the portion of income reasonably attributable to this state and thus subject to the bank and corporation franchise tax. Corporations deriving income from sources both within and outside the state are required to report the income of all related business units in a combined report. The combined income derived from all business activity is apportioned to each state or nation using an apportionment formula. The percentage of property, payroll, and sales attributed to California, versus worldwide operations, is calculated. They are then added together with double weight given to sales and divided by four. This calculation determines the percentage of the unitary or combined income subject to California's bank and corporation franchise tax.

Apportionment Formula = percentage of unitary income subject to California's corporate tax.

California Payroll (percent)+ California Property (percent)+ California Sales (percent) + California Sales (percent)

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Multinational corporations may make a "Water's Edge" election whereby they exclude most income derived from foreign operations from the combined report. Foreign business units or corporations that have an apportionment percentage in excess of 20 percent must be included in the combined report. The election lasts for seven years, but is continuously renewed unless a notice of non-renewal is filed by the business.

Sales and Use Tax

Administered by the Board of Equalization, the State of California and local jurisdictions impose sales and use tax that averages approximately 7.25 percent. The sales tax applies to the gross receipts of retailers from the sale of tangible personal property which is not specifically exempt. Specific exemptions include most food for home consumption and prescription medicine. Sales tax is imposed at the point of sale. It is the responsibility of the retailer, but paid by the purchaser.

Use tax is paid on items purchased for the intent of use in California. Intent of use is defined as used in California within 90 days of purchase. The tax is self-reported and paid at the rate applicable in the jurisdiction in which the item will be used less the tax paid in another state.

Note: Construction materials are not exempt from sales tax. Construction labor is not taxed.

For more information, visit the Board of Equalization's website at www.boe.ca.gov.

Property Taxes

County government levies and administers property taxes. The State Board of Equalization performs an oversight role relative to the county assessors' activities. The tax rate is 1 percent plus a component representing bonded indebtedness for the district in which the property is located on the lien date. **The average rate in California is 1.1 percent, but varies on a parcel basis.**

The tax is levied on 100 percent of assessed valuation. Real property is assessed at market value, then increased annually the lower of 2 percent or the rate of inflation as measured by the Consumer Price Index. Assessed values on real property may be reduced if the value is higher than the current market value.

Annual review and adjustment will occur until the adjusted value equals the original value plus the 2 percent adjustments. Real property is reappraised upon change of ownership or new construction. Typically the value of new construction is added to the current appraised value.

Business personal property, including machinery, equipment, and fixtures is taxed at the same rate as real property, but is not subject to any special assessments. Unlike real property, business personal property is reappraised annually. Business owners must file a property statement with the county assessor each year detailing market value. *Finished goods and raw materials are not subject to tax. Only finished goods held for use are assessed.*

For more information, visit the Board of Equalization's Property Tax site at http://www.boe.ca.gov/proptaxes/proptax.htm

Payroll Tax

All employers are required to pay into the Unemployment Insurance Fund, which is used to pay unemployment benefits. All new employers are required to pay a rate of 3.4 percent on the first $7,000 in wages for the first three years. In the fourth year, the tax rate is reevaluated based on the employer's tax payment history, employment history, and potential future unemployment. In addition, 0.1 percent of the first $7,000 in wages is paid to the Employment Training Panel. The average tax rate is 4.64 percent.

For more information, visit EDD's Payroll Tax page at http://www.edd.ca.gov/taxind.htm.

Disability Insurance

The withholding rate for tax year 2004 is 1.18 percent and the taxable wage limit for DI withholding is now at $68,829. Administered by the Employment Development Department, this is an *employee paid tax.*

For more information, visit EDD's Payroll Tax page at http://www.edd.ca.gov/taxind.htm.

Workers' Compensation Insurance

The workers' compensation system is overseen by the Department of Industrial Relations and the Department of Insurance. Private insurance carriers in California provide Workers' Compensation Insurance under a new "open-rating" system.

During 2003, the California Insurance Commissioner spearheaded reform legislation that was signed into law. This first wave of reform served to cap the escalating costs in California by targeting medical and vocational rehabilitation costs. In fact, it is estimated to provide a cost reduction of approximately 4 percent. More costs reductions are anticipated in the 2004 legislative session.

To ascertain the cost of coverage, employers must contact an insurance company offering workers' compensation insurance. Pure premium rates approved by the Insurance Commissioner reflect only loss costs, including loss adjustment expenses; they do not include any provision for general expenses, commissions, other acquisition expenses, premium taxes, or profits. Pure premium rates are not mandatory; they are advisory only. The industry is free to charge rates they deem competitive.

Overview of California Tax System

Tax	Base or Measure	Rate	Administering Agency
Corporation Income or Bank and Corporation Franchise Tax	Combined net income apportioned to California.	8.84 percent	Franchise Tax Board
Sales and Use Tax	Receipts from sales or lease of taxable items.	7.25-8.25 percent	Board of Equalization
Property Tax	100 percent of assessed valuation	Avg. 1.1 percent	County Government
Personal Income Tax	Taxable personal income.	1-9.3 percent	Franchise Tax Board
Unemployment Insurance Tax (aka Payroll Tax)	First $7,000 of wages per employee per year.	4.64 percent (average tax rate)	Employment Development Department
Disability Insurance (employee paid)	Taxable wage limit withholding is now at $68,829.	1.18 percent	Employment Development Department
Finished Goods, Raw Materials, and Inventory Tax	NONE	NONE	NONE
Workers' Compensation Insurance	Per $100 of payroll.	Varies based on job classification, workplace safety record, and insurance carrier.	Department of Insurance, Department of Industrial Relations

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